Leadership Concept Series

Risk Management: A Case of Misdirection

Excerpted from the book:

It Comes Down to This

Leadership, Management, and Getting from Here to There

By Chris Kaufman

Available September 2011 from Amazon, Barnes & Noble, and other fine book sellers.

Ernst Hardware and the Greatest Risk – A Story

In 1893, two brothers, Fred and Charles Ernst, opened a hardware store in Seattle. Ernst Hardware, later Ernst Home & Nursery, survived the ups and downs of the retail hardware business for a century. By 1992 Ernst was in undisputed control of the retail hardware middle-market in the Pacific Northwest. Five years later, in January of 1997, Ernst closed the last of its stores; the victim of unbridled risk behavior and hubris on the part of its management team.

Ernst Home & Nursery was in an enviable position. In 1991, Pay-&-Pak, their only serious competitor in the mid-market space, filed for Chapter 11. The following year Pay-&-Pak closed the last of its stores. This left Ernst as the only place to shop for hardware and home improvement goods which provided a shopping experience between mom-and-pop corner stores and big-boxes like Eagle, Lowes, and Home Depot. They had good locations, were close to family neighborhoods, and always had parking. They had a reputation for a knowledgeable staff known as the "Fellows-in-Yellow" who were willing to help and give good advice. Both men and women were comfortable shopping at Ernst. The stores were small enough not to be confusing and large enough to have everything contractors needed to build a house. They were staffed locally and developed a strong relationship-based business. Life should have been good.

Ernst owned a market niche. They had positioning. They had penetration. They had loyal, repeat customers. Many of their locations had been owned by the corporation for decades, thus lowering their overhead. They had economies of scale. And then they turned their back on what they were.

Instead of capitalizing on their unique positioning and value, Ernst decided to play in the big boys' sand box. In 1994 Ernst went public and began building superstores in the western states. From the start the effort was clearly and recognizably ill-conceived. Over the years the management team had received advice multiple times from consultants and employees telling them to embrace and build on what they were rather than reinventing themselves in a model defined by others. They were moving into a business space they did not need and did not understand. As icing on the cake, they were entering the big-box market just at the time the space was becoming saturated.

In 1996, Ernst filed for Chapter 11 bankruptcy. In 1997, they closed their last store. Over 8,000 people lost their jobs. The end of a century of good work brought on by high-risk behavior on the part of a few people.

The Ernst executive team was not afraid of the big boys. They should have been afraid of themselves.

* * *

Risk Management and Misdirection

The sad truth is this: most organizations spend the lion's share of their risk management effort on things that are never going to happen. They spend little or no time on things which actually create risk and regularly cost billions of dollars. Most risk management activities are centered on the preventing or mitigating "events." Most industry definitions center on this as well. Broad-thinking people will understand the word "event" should be read as "occurrence" or just "oops!" "Event," however, is more regularly interpreted as a point-in-time catastrophe or acute situation.

Earthquakes, mudslides, data breeches, and flu pandemics are easy to get our heads around. They are dramatic and reasonably simple to imagine and devise mitigation strategies for. All of us can visualize swaying skyscrapers and buckling bridges. For this reason, we regularly see companies running drills with their Emergency Operations Committees for 300 year events. We create calling-trees and fail-over sites. We buy emergency rations and stockpile bottled water in the basement. We have identified the corporate spokesman to answer press queries in a disaster or catastrophe.

Now, real quick, how many businesses can you name that have died due to failures of their disaster recovery or business continuity programs? It has happened, of course, but if you set aside businesses impacted by the 9-11 attack, you may scratch your head for a while to think of any.

The real risk to continuity of most businesses occurs in the executive suites, not in the market or the tectonic plates of the earth.

An Example close to the Heart

An absolutely stellar and close to the heart example of the principles of risk management at work can be seen in the case of home ownership and insurance. If a bank holds a mortgage on your home, they will insist you carry fire insurance. If the house burns down, the bank is covered and you are covered. The house is paid off or rebuilt and everyone is happy.

On the other hand, the bank has no requirement you have life insurance. If you die before the house is paid-off and your family cannot make the payments, the bank is protected. They simply take the house, sell it, and get their money. Your family gets anything that happens to be left over. Yet, it is seven times more likely you will die before your house is paid off than your house burn down. The bank is managing its risk, not yours.

Risk Concepts

The definition of "risk" is conceptually easy to understand. It is simply the exposure or amount of a potential loss and the likelihood the loss will occur. In other words, what are the odds the situation will occur and what will it cost us if it does. Risk management is about balancing the exposure, likelihood, and the cost to prevent or manage the event. Here are some examples of simple risk calculations:

- **Head injury while bicycling**:
    - Exposure: High
    - Likelihood: Low
    - Risk Management: Cheap (Wear a helmet and ride defensively)
    - Conclusion: Actively manage risk reduction
- **Frozen outside faucets in winter:**
    - Exposure: Low to Medium
    - Likelihood: Medium
    - Risk Management: Cheap: Faucet covers and weather awareness
    - Conclusion: Actively manage risk reduction
- **Occasional seepage in basement due to heavy rain:**
    - Exposure: Low
    - Likelihood: Medium
    - Risk Management:
        - Prevention: Expensive: French drain and basement seal
        - Mitigation: Cheap: Easily removable throw rugs and weather awareness
    - Conclusion: Initially mitigate and minimize exposure (throw rugs). Install preventative infrastructure when surplus funds are available
- **Death of family bread winner:**
    - Exposure: Extremely high
    - Likelihood: Low
    - Risk Management: Medium: Life insurance
    - Conclusion: Actively manage risk reduction
- **Cat litter box stains hardwood floor:**
    - Exposure: Low
    - Likelihood: Medium
    - Risk Management: Cheap: Plastic layer between litter box and floor
    - Conclusion: Actively manage risk reduction

Each of the above is fairly easy to picture and evaluate. Corporate and organizational risk evaluation and management, however, is more complex and difficult. Because it is not easy, risk management in an organizational setting tends to gravitate to more concrete risks. Earthquakes, terrorist attacks, data breaches, corporate espionage are all examples of well-defined risks. There are many risk management methods and standards for concrete and understandable event-based risks. Organizations, frameworks, and standards bodies with useful information include: ISO, ITIL, EMC, IRM, AIRMIC, and others. Any competent risk manager or consultant can guide you through the development of a risk management plan for concrete exposures and eventualities.

Be clear: You need to manage your concrete, event-driven, and predictable risks. Do not interpret anything said here to imply event-based risk management is unnecessary. It would be irresponsible not to manage and control those risks. The primary message of this conversation, however, is this: your primary exposure is caused by executive and management risk behavior and decision-making. These behaviors must be managed and controlled as well. You may or may not suffer a loss due to exposure to event risks. It is a near certainty you will experience losses due to executive risk behavior.

The Real Risk of Human Behavior and Business Decisions

The risk behaviors most likely to cost money, prevent achievement of success, or bring an organization to its knees, occur in day-to-day management activities. Cast your mind back to the times your organization has been most challenged or experienced a major and unpredicted failure. These can usually be traced to risk behaviors outside the traditional bailiwick of risk management. Here are some examples of risk behavior you may have seen:

- **Date-Driven Releases:** Executive chests tend to swell with macho pride when they talk of holding people accountable to delivery dates. Outcome: products and systems are frequently released before they are ready. The ramifications can be devastating. Potentially good products fail to get a market foothold and new systems do not work. The customer gets the message; we do not know what we are doing. Refunds are required, product given away free, and customers leave. Remember this: Although you must drive for expeditious and predictable development and delivery, a year from now no one will remember if a project or product came in three months late. Everyone will remember if you screwed up your reputation, your customer base, or very publically spent millions of dollars to fix a bad delivery.
- **Expense Management:** If you cannot get your cost of goods and operations to a predictable and managed level to support competitive pricing, you will go out of business.
- **Trade and Industry Conferences (and any trade magazine):** Industry conferences and trade magazines have been responsible for more blockheaded purchases of systems, products, and consulting services than any other single culprit. It is exactly like buying a whistle from a hawker on the State Fair midway. The hawker lit up the night with sounds like a forest of song birds. When you got home and tried it, all you got was a wheezy blow. The hawker did not lie exactly; the whistle can make that sound. It takes about a year of practice, that's all.
- **Accountability:** If you do not hold yourself and your team accountable to your commitments and for achieving results, you will not succeed and you will not be able to make plans for the future. Your marketing executive must create a call-to-action for potential customers and bring business to your door. Your sales executive must make sales. Your operations executive must consistently and predictably run the operation at a planned level of spending. Your information technology executive must

deliver dependable and secure systems support within a supportable cost structure. If you make a commitment to increase your customer base by so-many thousands over twelve months, it cannot disappear in June or July when it becomes clear you will not make it. Etc.

- **Cronyism and Nepotism:** It is okay to hire your friends and relatives if they produce results. The problem is most of the time they do not. Neither birth nor friendship qualifies an individual to hold a position.

Bottom Line

If your organization is managing for catastrophic risks, technology risks, and physical risks, but not managing business decisions and operations in terms of their potential risk, you are scraping rust on a ship in a typhoon. You should certainly manage for potential disasters. It is the prudent thing to do. However, for every company eliminated by a catastrophe, a thousand are killed by bad decisions on the part of their executives and leaders. Is it not worth putting some energy there as well?

* * *

Chris Kaufman advises organizations on Strategic, Tactical, and Operational planning and execution.
If you have decided to succeed, Chris can help you chart the course.

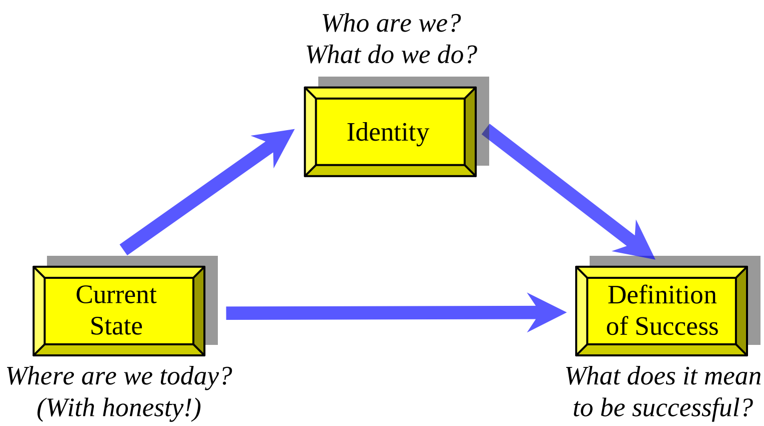
He is also available to speak on Leadership and Management or facilitate your corporate or industry event.
He brings common sense, commitment to results, and an eye for the absurd to all his engagements.

To talk about it, get in touch: (206) 708-5176 || chriskaufman@agovia.com.

Agovia
Manage to Success

Success: Decide to do what is necessary || Plan rapidly || Execute effectively

Agovia works with leadership teams. Our strength is common sense advice and management consulting. We are not theorists, we are realists. Everything we do is built around outcomes and results. Our focus is the whole business and the organization. We help organizations take control and manage their road to the future. We begin with achievement of clarity and understanding of the three elements upon which a deliberate path to success can be built:



Once known, everything else is possible. We help our clients rediscover and use the basic tools of management and leadership to craft and control their journey to success. We do it effectively, rapidly, and with a sense of humor.

Success is achievable. Experience says your team has the necessary talent and brains. We get the team around a table and we hammer out who we are, where we are going, and how to get there.

If you are stuck, caught in the grip of inertia, or just need a hand, we can help you get perspective, establish structure, and get moving. A firm decision to succeed is the most important ingredient. Once you have the commitment, together we can find a way to make it happen.

Go beyond management for success. Take control and manage *to* success.
Call us. Let's talk.

Strategy • Tactics • Operations • Organization

Planning and Execution for Results

Agovia

www.agovia.com || (206) 708-5176

We listen || We pay attention || We work with you